# Corporate reporting obligations arising from audit reform

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| **Lead department** | Department for Business and Trade |
| **Summary of proposal** | The Government propose to reform the UK's audit, corporate reporting and corporate governance system, to ensure that investors and other stakeholders have enough information to assess the risks involved in dealing with different companies. |
| **Submission type** | Impact assessment (IA) – 24 April 2023 |
| **Legislation type** | Secondary |
| **Implementation date** | 1 January 2025 for companies whose equity capital is traded on a UK regulated market and 1 January 2026 for any other company. |
| **Policy stage** | Final |
| **RPC reference** | RPC-DBT-5271(1) |
| **Opinion type** | Formal |
| **Date of issue** | 5 July 2023 |

## RPC opinion

| **Rating**[1] | **RPC opinion** |
|---|---|
| Fit for purpose | Initially, the IA received an initial review notice (IRN) from the RPC. The SaMBA remains sufficient as the IA states explicitly that the proposed measures will not apply to companies with less than 750 employees and below £750 million in turnover. Since the IRN, the Department has provided additional text to communicate limitations in data as part of the EANDCB calculation and improved its description of the counterfactual. The Department has committed to a post-implementation review (PIR), five years after the legislation comes into force. The PIR should capture any indirect impacts of the measures, including potential innovation impacts briefly discussed in the IA, and also test the robustness of estimations and assumptions made in the IA. |

[1] The RPC opinion rating is based only on the robustness of the EANDCB and quality of the SaMBA, as set out in the Better Regulation Framework. RPC ratings are fit for purpose or not fit for purpose.

# Business impact target assessment

| | Department assessment | RPC validated |
|---|---|---|
| **Classification** | Qualifying regulatory provision (IN) | Qualifying regulatory provision (IN) |
| **Equivalent annual net direct cost to business (EANDCB)** | £53 million (final IA estimate) | £53 million (2019 prices, 2020 present value) |
| **Business impact target (BIT) score** | £265 million | £265 million |
| **Business net present value** | -£458 million | |
| **Overall net present value** | -£458 million | |

# RPC summary

| Category | Quality[2] | RPC comments |
|---|---|---|
| EANDCB | Green | The IA has addressed sufficiently the concerns raised in the RPC's IRN. There remain some areas that could benefit from strengthening, mainly adjusting the IA's use of language to facilitate clearer explanations (see 'EANDCB' section below). |
| Small and micro business assessment (SaMBA) | Green | While brief, the SaMBA is sufficient as the IA states explicitly that the proposed measures will not apply to companies with fewer than 750 employees and less than £750 million in turnover. |
| Rationale and options | **Satisfactory** | The rationale for intervention is underpinned by case studies in the absence of good information and the risks this creates for companies and the wider economy, e.g., the collapse of Carillion. The policy objectives for each proposed measure have been set out clearly. The IA's consideration of alternative options could be improved, and more detail should be provided on why non-regulatory options were not explored or why they would not be appropriate. |
| Cost-benefit analysis | **Weak** | The IA does not explain clearly the calculations behind its present value cost figures for the different policy measures. The IA should also explore alternative options to reduce the uncertainty of its cost estimates. |
| Wider impacts | **Satisfactory** | The IA states that it does not expect the policy measures to have impacts on a range of areas, explained in more detail in the 'Wider impacts' section below. While innovation has been discussed briefly, the Department should take a more evidence-based approach to its conclusion that innovation impacts will be "marginal and mixed at best". |
| Monitoring and evaluation plan | **Satisfactory** | The Department commits to a PIR five years after the regulations come into force. An adequate approach to monitoring and evaluation is set out, along with examples of success factors against which the performance of the regulations will be measured. |

[2] The RPC quality ratings are used to indicate the quality and robustness of the evidence used to support different analytical areas. The definitions of the RPC quality ratings can be found here.

# Response to initial review

As originally submitted, the IA was not fit for purpose as it lacked supporting evidence for key assumptions and analysis, which could have material impact on the EANDCB figure, e.g., the IA's estimated cost of £87,000 per company to reverse stress-test. In addition, the IA's description of the counterfactual did not discuss the actions businesses may have taken in the aftermath of the Carillion collapse and whether evidence from current business reporting informed the analysis. The IA gave little consideration to why investors did not demand better reporting information and more assurances from companies, and why company management would not respond to those demands in order to attract investors. Finally, the IA needs to provide more clarity on indirect impacts on businesses, which were neither explicitly set out, nor monetised.

The Department has now expanded on the counterfactual description (paragraph 20), by explaining how 'additionality' factors were used to account for changes in the aftermath of the Carillion collapse. The explanation could be strengthened by providing the exact additionality factors that informed the counterfactual. The IA could also be clearer about when the Financial Reporting Council Lab identified these additionality factors, as the source studies may be outdated.

The IA now provides transparency about being unable to test the validity of its £87,000 cost estimate, as stated in the IRN, and describes how changes to this figure would have an impact on the EANDCB. It would be beneficial for the IA to describe how this sensitivity analysis was conducted. In addition, the IA commits to testing this assumption as part of the PIR; however, it would be beneficial for the IA to explain how this testing will occur. The IA now provides more clarity around the assumption, in its best-case scenario, that 30 per cent of companies already reverse stress-test (paragraph 125).

Moreover, the IA now includes a section (paragraphs 26-34) that outlines its approach to classifying direct and indirect impacts. The IA is now clear around the difficulties in gauging exact indirect impacts *ex-ante*. The Department must ensure that the PIR captures *ex-post* direct and indirect impacts.

# Summary of proposal

The IA covers four measures in the Government's package of audit reforms, which will be implemented by secondary legislation. These include requirements for some companies to:

- produce and report on their audit and assurance policy;
- report on their distribution policy and distributable reserves and confirm that distributions from profits have been made available for the purpose;
- report on measures to prevent and detect fraud; and
- report on their resilience to material risks.

Many of these measures were recommended by the Brydon Review[3], which was one of three policy reviews set up, after the failure of Carillion, to recommend improvements to audit and corporate reporting. The Government consulted on these measures in March 2021[4]. In their response in May 2022[5], the Government confirmed that they would proceed with their proposals to introduce these measures and that they would apply to companies that meet a "750 test" – companies with at least 750 employees and £750 million or more in annual turnover.

The IA splits the options considered for each measure being proposed. The measures and associated options considered are as follows:

*Audit and Assurance Policy (AAP)*

- Option 1 – Do nothing: the Government will not pursue the 'Do nothing' option for the reasons set out in in the Government's response paper on 'Restoring Trust in Audit and Corporate Governance' in May 2022[6].
- Option 2 – Require those in scope to report on audit and assurance policies.

*Capital Maintenance and Distribution Policy*

- Option 1 – Do nothing: the Government will not pursue the 'Do nothing' option as it would not address the high-profile examples of companies paying significant dividends shortly before profit warnings and insolvency.
- Option 2 – Strengthened law on dividends and capital maintenance.

*Reporting on Measures to Prevent and Detect Fraud*

- Option 1 – Do nothing: the Government will not pursue the 'Do nothing' option for the reasons set out in the White Paper and in the Government's response in May 2022.
- Option 2 – Require directors of those companies in scope to report, as part of their annual directors' report, on the steps that they have taken to prevent and detect material fraud in that financial year.

*Resilience Reporting*

- Option 1 – Do nothing: the Government will not pursue the 'Do nothing' option as this does not address concerns that existing risk and viability reporting by many companies – including the viability statement produced under the UK Corporate Governance Code – lack sufficient detail and specificity and is not sufficiently long-term in outlook.
- Option 2 – Companies in scope will be required to produce a Resilience Statement meeting the requirements described above.

3 https://www.gov.uk/government/publications/the-quality-and-effectiveness-of-audit-independent-review

4 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/970673/restoring-trust-in-audit-and-corporate-governance-command-paper.pdf

5 https://www.gov.uk/government/consultations/restoring-trust-in-audit-and-corporate-governance-proposals-on-reforms

6 Government response can be found on pages 45-47

For all of the measures set out above, the IA estimates an indicative net present value of £458 million over a 10-year appraisal period (2019 price base, 2020 present value). The IA is transparent about challenges in monetising anticipated benefits due to uncertainty (paragraph 152), i.e., it would be difficult for benefits to be realised due to the preventative nature of the measures being proposed. Costs are estimated to total £459 million across all of the proposed measures, including familiarisation and compliance costs. The IA reports a total EANDCB figure of £53 million (2019 prices), for all of the proposed measures, and a business net present value figure of -£458 million.

# EANDCB

While the main concerns noted in the IRN have now been addressed adequately, the IA would benefit from improving the clarity of its language. For example, paragraph 36 states that the bulk of the work for producing the AAPs would fall to a central team; this text could be strengthened by explaining whether consultation or stakeholder engagement informed this assumption. Paragraph 32 explains that the Department identified the process that a “reasonably efficient” company may adapt to gather and assess information required to comply with reporting requirements. The IA could benefit from explaining how a “reasonably efficient” company has been defined.

Paragraph 74 states that the assumption that 20 per cent of companies already calculate distributable profits is based on old data. The IA would benefit from testing this assumption or using supplementary evidence to improve its robustness, in order to mitigate the risks posed by using old data.

# SaMBA

The SaMBA is adequate as the IA states explicitly that the proposed measures will not apply to companies with fewer than 750 employees and less than £750 million in turnover. The IA makes clear that the proposed measures will not create costs for small, micro and medium-sized businesses.

# Rationale and options

*Rationale*

The principal-agent problem is central to the rationale for intervention; issues of moral hazard and externalities are also briefly discussed (paragraph 17). With regards to the principal-agent problem, the IA would benefit from discussing the role of financial markets in identifying and pricing associated risks and whether the proposed measures consider the different status of companies like Carillion, which build their business on public procurement.

The IA explains the method by which the Department identified the estimated number of entities in scope of the proposed regulatory changes, and the approach taken to identify additional entities that may be in scope but not captured by the methodology.

*Options*

The Department has now added text (paragraph 19) explaining its dismissal of non-regulatory options. However, this discussion remains weak; it could be strengthened by explaining the potential consequences of limited reporting information availability and reduced comparability across companies for companies, financial markets and their customers, e.g., investors or those with pension funds from companies in scope of the policy proposal. It would be beneficial for the Department to discuss non-regulatory means to improve the reporting conduct of companies and explain why such approaches would not achieve appropriately the policy objectives, e.g., investors potentially withholding investment funds or – more likely – demanding greater risk premia if reporting information is unclear. Furthermore, the IA could be improved by considering alternative approaches, either regulatory or non-regulatory, used abroad to address issues of inconsistent corporate reporting or potential consequences of a lack of standardisation.

Paragraph 18 briefly considers the possibility that companies already provide voluntarily the corporate reporting information that the measures seek to standardise. However, this discussion could benefit from more detail, e.g., what proportion of companies that would be in scope, already provide 'full' corporate reporting information? The IA could benefit further from discussing how well such companies perform, relative to those who do not report in 'full'. Similarly, paragraph 28 states that the AAP is expected to provide greater clarity to investors and other stakeholders and go beyond the narrow scope of financial information assurance; the IA would benefit from providing evidence on the standardisation of corporate reporting, on company outcomes, e.g., fewer insolvencies.

Regarding extra burdens being placed on directors rather than auditors, paragraph 21 now states that it is the responsibility of company directors to take the necessary steps to ensure that companies are well-run. Whilst this is true, the statement could be strengthened through using legal definitions that distinguish between the remits of directors (or management) and auditors.

In the IRN issued to the Department, a particularly weak piece of analysis was identified, whereby the IA had claimed a causal relationship between the collapse of Carillion and construction sector insolvencies. The IA has now clarified that there is no causal relationship between the two, and expands on its use of interrupted time series analysis as set out in the Magenta Book. There remains an area for improvement around establishing whether the impact of the collapse of Carillion created long-term impacts, as is still claimed by the IA.

# Cost-benefit analysis

The IA must be explicit about the calculations that result in its present value cost figures, as it is currently not intuitive how they are derived for each proposed measure. The IA should also explore alternative options to wide ranges for its cost estimates, to reduce uncertainty.

The IA now includes text (paragraph 34), which briefly discusses the degree of duplication in cost estimates. The IA states that duplication is likely to occur in discussions at board level if boards choose to discuss reporting requirements together rather than individually. However, no further insights have been collected by the Department to inform the assumption that there would be no synergies between reporting requirements. The Department should, therefore, monitor this, post-implementation.

In the IA's break-even analysis, paragraph 155 states that at least one major corporate failure on a par with Carillion, would need to occur every 10 years for the reforms to break even. The IA must explain how, and based on what information, this conclusion is reached.

# Wider impacts

The IA states that it does not expect the policy measures to have any impacts on the following areas:

- Convention rights of any person or class of persons
- Criminal offences
- Family well-being
- Human rights
- Environment
- Rural communities

The IA does not present any assessments to support these conclusions, however, they seem logical given the nature of the policy measures being proposed.

Furthermore, the IA now includes text in paragraph 158, which discusses innovation, but there is no evidence to support the claims made. It is, therefore, crucial that monitoring of the policy measures post-implementation, capture any indirect or unintended impacts on factors such as innovation. In addition, the IA would benefit from discussing the indirect impacts of the proposed measures, on debt and equity markets.

# Monitoring and evaluation plan

The IA commits to a post-implementation review (PIR) five years after the regulations come into force; whether the regulations remain in place, will depend on their performance against numerous success factors, some of which are described in paragraph 169. The M&E plan also outlines the Department's approach to evaluation, which appears adequate for this final stage IA. In addition to using the PIR to validate the IA's cost assumptions and identify early indirect impacts of the regulations, the Department should provide intuitive detail on and discussion of any stark differences between the appraisals in the IA and the PIR.

**Regulatory Policy Committee**

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